

## Message Text

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INFO AMEMBASSY TOKYO IMMEDIATE

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PASS CEA, TREAS, FRB

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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE  
(EDRC) REVIEW OF JAPAN

REF: EDR(77)19

1. SUMMARY: IN REFDOC CIRCULATED FOR JUNE 27 EDRC  
REVIEW OF JAPAN, SECRETARIAT NOTES THAT DECELERATION  
OF EXPORT GROWTH (THE MAIN SUPPORT TO GNP GROWTH LAST  
YEAR), COMBINED WITH SIMILAR MOVEMENT OF PRIVATE  
CONSUMPTION AND PUBLIC SPENDING, INDUCED PRONOUNCED  
DECLINE IN RATE OF GNP INCREASE DURING 1976. EXPORTS  
LED STRONG PICK-UP IN ECONOMIC ACTIVITY IN FIRST  
QUARTER OF 1977, BUT DESPITE GREATER FISCAL STIMULUS,  
DOMESTIC DEMAND (ESPECIALLY MANUFACTURING INVESTMENT)  
REMAINED RELATIVELY WEAK. SECRETARIAT FORECASTS 5.5  
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PERCENT INCREASE IN REAL GNP IN 1977, WITH DECELERATION  
TO 5 PERCENT GROWTH AT ANNUAL RATE IN FIRST HALF OF  
1978. SECRETARIAT PROJECTS ACCELERATION IN GROWTH  
RATE OF DOMESTIC DEMAND IN SECOND HALF OF 1977 AND  
NEGATIVE CONTRIBUTION OF REAL FOREIGN BALANCE TO GNP  
GROWTH, BUT NONETHELESS PROJECTS \$6 BILLION CURRENT  
ACCOUNT SURPLUS FOR YEAR AS WHOLE. MOREOVER,

SECRETARIAT EXPECTS CONTRIBUTION OF REAL FOREIGN BALANCE TO GNP GROWTH TO AGAIN TURN POSITIVE IN FIRST HALF OF 1978, IMPLYING THAT GROWTH OF GNP WILL EXCEED THAT OF TOTAL DOMESTIC DEMAND. SECRETARIAT EMPHASIZES THAT SUCH AN EXPECTED COMPOSITION OF JAPANESE GNP GROWTH IS INCONSISTENT WITH REQUIREMENT THAT COUNTRIES IN STRONG EXTERNAL POSITIONS ABSORB A LARGER PORTION OF THE OECD AREA CURRENT ACCOUNT DEFICIT IN ORDER TO HELP BRING ABOUT A SUSTAINABLE INTRA-OECD PAYMENTS PATTERN. IN DETAILED ANALYSIS OF RECENT WEAKNESS OF MANUFACTURING INVESTMENT, SECRETARIAT CONCLUDES THAT EXCESS CAPACITY, LOWER PROFITS, HEAVY INDEBTEDNESS OF FIRMS AND WEAK GROWTH EXPECTATIONS HAVE ALL ACTED AS DEPRESSANT FACTORS. MAIN SECRETARIAT CONCLUSION IS THAT ADDITIONAL FISCAL STIMULUS WOULD BE APPROPRIATE FROM BOTH INTERNATIONAL AND DOMESTIC STANDPOINT; APPRECIATION OF YEN WOULD FACILITATE EXTERNAL ADJUSTMENT AND WOULD HAVE FAVORABLE IMPACT ON INFLATION. ACTION REQUESTED: MISSION WOULD APPRECIATE COMMENTS/ QUESTIONS WHICH COULD USEFULLY BE POSED AT REVIEW. FOR TOKYO: MISSION WOULD WELCOME EMBASSY'S COMMENTS ON SECRETARIAT'S ANALYSIS AND RECOMMENDATIONS. END SUMMARY

2. DOMESTIC DEVELOPMENTS IN 1976: SECRETARIAT NOTES THAT JAPANESE GNP GROWTH INCREASED RAPIDLY DURING FIRST LIMITED OFFICIAL USE

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HALF OF 1976 (8.7 PERCENT ANNUAL RATE), BUT TRAILED OFF SHARPLY TO ANNUAL RATE OF 2.9 PERCENT IN SECOND HALF OF YEAR. DECELERATION WAS INDUCED BY DECLINE IN RATE OF INCREASE OF PRIVATE CONSUMPTION AND OF EXPORTS AND BY ABSOLUTE DECLINE IN RESIDENTIAL CONSTRUCTION AND GOVERNMENT SPENDING. ALTHOUGH REGISTERING ITS FIRST INCREASE IN TWO YEARS, PRIVATE INVESTMENT REMAINED WEAK, RISING BY ONLY 2.1 PERCENT. DRAMATIC REVIVAL OF EXPORT GROWTH CAUSED REACCELERATION OF EXPANSION IN FIRST HALF OF THIS YEAR, BUT DESPITE INCREASED FISCAL STIMULUS, DOMESTIC DEMAND (PARTICULARLY MANUFACTURING INVESTMENT) REMAINED SLUGGISH. SECRETARIAT POINTS OUT THAT EXCESS MANUFACTURING CAPACITY REMAINS SUBSTANTIAL AS DOES DEGREE OF SLACK IN LABOR MARKET. ANNUAL RATE OF INCREASE IN CONSUMER PRICES HAS BEEN STABLE AT ABOUT 9.5 PERCENT SINCE EARLY 1976.

3. DOMESTIC OUTLOOK FOR 1977 AND FOR FIRST HALF OF 1978: SECRETARIAT NOTES THAT STIMULATORY MEASURES TAKEN BY GOJ IN RECENT MONTHS WILL STRENGTHEN DOMESTIC DEMAND IN 1977, BUT ADDS THAT TIMING AND IMPACT OF

THESE MEASURES IS UNCERTAIN. UHILE FORECASTING

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RELATIVELY MODERATE (4.25 PERCENT) INCREASE IN PRIVATE CONSUMPTION ON AVERAGE FOR 1977, SECRETARIAT EXPECTS CONSUMPTION SPENDING TO ACCELERATE TO ANNUAL RATE OF ABOUT 7 PERCENT IN SECOND HALF OF YEAR DUE TO (A) 9 PERCENT INCREASE IN BASIC WAGES (VS. 8.8 PERCENT LAST YEAR) GRANTED IN SPRING WAGE ROUND; (B) HIGHER SUMMER BONUS PAYMENTS THAN IN 1976; (C) CUT IN PERSONAL INCOME TAXES (HALF OF WHICH IS TO BE PAID OUT AS A REBATE IN JULY); (D) MORE RAPID RISE IN EMPLOYMENT; AND (E) DECELERATION OF CONSUMER PRICE INCREASES. HOWEVER, SECRETARIAT EXPECTS EXCESS CAPACITY AND SORRY STATE OF BUSINESS CONFIDENCE TO RESULT IN VIRTUAL STAGNATION OF PRIVATE PRODUCTIVE INVESTMENT OVER NEXT TWELVE MONTHS. SECRETARIAT FORECASTS 5.5 PERCENT INCREASE IN GNP IN 1977.

4. SECRETARIAT NOTES THAT EMPLOYMENT COULD RISE BY ABOUT 1 PERCENT IN 1977, BUT THAT UNEMPLOYMENT RATE IS NOT LIKELY TO DECLINE FROM 1976 LEVEL (L.9 PERCENT)  
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DUE PROBABLE INCREASE IN PARTICIPATION RATE. CONSUMER PRICE INCREASES SHOULD MODERATE SOMEWHAT DURING 1977 TO RECORD AVERAGE YEARLY INCREASE OF 8.75 PERCENT COMPARED TO 9.3 PERCENT RISE IN 1976.

5. IN FORECAST FOR FIRST HALF OF 1978, SECRETARIAT ASSUMES THAT (A) IMPACT OF RECENT FISCAL POLICY STIMULUS WILL BE TEMPORARY AND (B) GOJ WILL NOT INTRODUCE A SUPPLEMENTARY BUDGET IN AUTUMN 1977. THUS, SECRETARIAT PROJECTS DECELERATION IN ANNUAL GROWTH RATE OF DOMESTIC DEMAND TO 4.5 PERCENT IN FIRST HALF OF NEXT YEAR, AFTER RISE OF 8 PERCENT IN SECOND HALF OF 1977. GNP GROWTH LIKELY TO FOLLOW SIMILAR PROFILE WITH ANNUAL RATE OF INCREASE DECLINING FROM 7 PERCENT TO 5 PERCENT BETWEEN LAST HALF OF 1977 AND FIRST HALF OF 1978. ONE BRIGHT SPOT: ANNUAL RATE OF CONSUMER PRICE INCREASE SHOULD, IN SECRETARIAT'S VIEW, COME DOWN TO ABOUT 7.5 PERCENT.

6. SECRETARIAT INDICATES THAT DURING PRESENT EXPANSION, IN CONTRAST TO PAST EXPERIENCE, MANUFACTURING INVESTMENT HAS NOT BEEN A DRIVING FORCE AND PRESENTS DETAILED ANALYSIS OF INVESTMENT DETERMINANTS IN JAPAN IN ATTEMPT TO IDENTIFY MAIN CAUSES OF WEAKNESS. SECRETARIAT POINTS TO FOLLOWING MAIN CONTRIBUTORY FACTORS: (A) EXISTENCE OF SUBSTANTIAL SPARE CAPACITY. (SECRETARIAT CITES EPA ESTIMATE OF 18 PERCENT CAPACITY UTILIZATION GAP IN MANUFACTURING SECTOR; ADDS THAT THIS CALCULATION IS BASED ON ESTIMATED UTILIZATION RATE WHICH MAY HAVE UPWARD BIAS. IMPLICATION IS, OF COURSE, THAT ACTUAL DEGREE OF EXCESS CAPACITY COULD WELL BE GREATER); (B) EFFORTS OF FIRMS TO PULL IN THEIR HORNS SO AS TO RESTRUCTURE

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DEBT-LADEN BALANCE SHEETS; (C) LOW LEVEL OF "REAL" PROFITS (NOMINAL PROFITS DEFLATED BY IMPLICIT PRICE DEFLATOR FOR INVESTMENT GOODS); (D) WEAK BUSINESS CONFIDENCE, RELATED NOT ONLY TO UNCERTAIN SHORT-RUN DEMAND PROSPECTS, BUT ALSO TO EXPECTATION THAT GROWTH WILL BE SLOWER IN MEDIUM TERM THAN IT HAS BEEN IN PAST. (GOJ MEDIUM-TERM PLAN CALLS FOR 6.25 PERCENT ANNUAL RATE OF GNP GROWTH BETWEEN 1976 AND 1980, IN CONTRAST WITH AVERAGE ANNUAL REAL GROWTH RATE OF 10 PERCENT IN TWENTY YEARS TO 1973.) SECRETARIAT QUALIFIES ABOVE ANALYSIS BY NOTING THAT CAPACITY UTILIZATION RATES AND

PROFITABILITY VARY SUBSTANTIALLY AMONG SECTORS.

7. CURRENT ACCOUNT: WITH GROWTH OF EXPORTS VOLUMES EXCEEDING THAT OF MARKETS BY WIDE MARGIN (22 PERCENT VS. 9 PERCENT -- SECRETARIAT POINTS TO UNCERTAINTIES SURROUNDING CALCULATIONS OF MARKET SHARES) AND WITH IMPORT GROWTH MODERATE, JAPAN RECORDED \$10 BILLION TRADE SURPLUS IN 1976 AND CURRENT ACCOUNT SURPLUS OF \$3.7 BILLION. (SECRETARIAT ESTIMATES THAT, INCLUDING MULTIPLIER EFFECTS, EXPORTS ACCOUNTED FOR 3-1/2 PERCENTAGE POINTS OF JAPANESE GNP GROWTH OF 6.3 PERCENT LAST YEAR.) SECRETARIAT NOTES THAT EXPORT VOLUME INCREASED RAPIDLY IN EARLY MONTHS OF 1977, BUT FEELS THAT RATE OF INCREASE WILL DECELERATE DURING REST OF YEAR. CONVERSELY, IMPORT GROWTH SHOULD ACCELERATE. WITH ASSUMPTION OF SMALL IMPROVEMENT IN JAPANESE TERMS OF TRADE (EXPRESSED IN YEN), SECRETARIAT FORECASTS CURRENT ACCOUNT SURPLUS OF \$6 BILLION IN 1977 DECLINING TO \$4 BILLION IN TWELVE MONTHS TO MID-1978. ACCORDING TO SECRETARIAT, CONTRIBUTION OF REAL FOREIGN BALANCE TO GNP GROWTH WAS POSITIVE IN FIRST HALF OF

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1977, WILL SHIFT TO NEGATIVE IN SECOND HALF OF THIS  
YEAR AND BACK TO POSITIVE IN FIRST HALF OF 1978.

8. FISCAL AND MONETARY POLICIES: SECRETARIAT NOTES THAT ACCELERATION OF PUBLIC WORKS EXPENDITURES, PURSUANT TO NOVEMBER, 1976 REFLATIONARY PACKAGE, PROVIDED SUPPORT TO GROWTH IN FIRST QUARTER OF THIS YEAR. MOREOVER, SECRETARIAT UNDERLINES GOJ INTENTION TO COMMIT 73 PERCENT OF PUBLIC WORKS APPROPRIATIONS CONTAINED IN FY 77 BUDGET BETWEEN APRIL AND SEPTEMBER, 1977. HOWEVER, SECRETARIAT FEELS THAT WHILE TIMING OF SUCH EXPENDITURE COMMITMENTS WILL HELP GROWTH IN 1977, IMPACT OF THESE MEASURES WILL BE TEMPORARY AND THAT GNP GROWTH WILL LOSE MOMENTUM IN FIRST HALF OF 1978. SECRETARIAT ALSO REFERS TO GOJ INTENTION OF REDUCING CURRENT BUDGET DEFICIT OVER MEDIUM TERM AND OBSERVES THAT FEASIBILITY AND PACE OF IMPLEMENTATION OF GOJ TARGETS ARE AMONG THE MANY PROBLEMS OF POLICY ADJUSTMENT POSED BY THE POSTULATED LIMITED OFFICIAL USE

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TRANSITION FROM HIGH GROWTH IN PAST TO MODERATE GROWTH IN FUTURE.

9. SECRETARIAT DESCRIBES JAPANESE MONETARY POLICY AS ACCOMMODATIVE IN 1976, NOTING THAT THE IMPACT OF MONETARY POLICY ON REAL VARIABLES WAS "RATHER LIMITED" LAST YEAR.

10. MAIN CONCLUSIONS: BASED ON ANALYSIS REFDOC, SECRETARIAT SUGGESTS THAT EDRC COME TO FOLLOWING MAIN CONCLUSIONS:

(A) ON BOTH DOMESTIC AND INTERNATIONAL GROUNDS, GOJ SHOULD ACT TO INSURE A GNP GROWTH RATE IN 1978 AT LEAST AS HIGH AS THAT EXPECTED IN 1977. MORE IMPORTANTLY, THE GROWTH OF DOMESTIC DEMAND SHOULD EXCEED THAT OF GNP IN ACCORDANCE WITH THE PRINCIPLE THAT THE STRONGER COUNTRIES SHOULD LEAD ECONOMIC RECOVERY IN THE OECD AREA;

(B) ADDITIONAL FISCAL STIMULUS WOULD HELP ACHIEVEMENT OF ABOVE OBJECTIVES AND WOULD BE CONSISTENT WITH AVOIDING THE REKINDLING OF INFLATION.

(C) FURTHER APPRECIATION OF YEN EXCHANGE RATE WOULD FACILITATE EXTERNAL ADJUSTMENT AND WOULD HAVE MODERATING EFFECT ON INFLATION RATE;

(D) OVER MEDIUM TERM, A RAPID INCREASE OF TAX REVENUE WILL BE REQUIRED IN VIEW OF EXPANSION OF PUBLIC EXPENDITURES IMPLIED BY ECONOMIC AND SOCIAL OBJECTIVES

OF GOJ'S MEDIUM TERM PLAN.

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11. COMMENT: (A) REAL FOREIGN BALANCE MADE POSITIVE CONTRIBUTION TO JAPANESE GNP GROWTH IN 1976 AND IS EXPECTED BY SECRETARIAT TO DO SO AGAIN ON AVERAGE IN 1977 (WITH NEGATIVE CONTRIBUTION IN SECOND HALF OF THIS YEAR) AND IN FIRST HALF OF 1978. MISSION WOULD USE OCCASION OF EDRC REVIEW TO REITERATE POINT THAT MOVEMENT TO SUSTAINABLE INTRA-OECD PAYMENTS PATTERN IMPLIES THAT CURRENT ACCOUNT BALANCE OF STRONGER COUNTRIES SHOULD MOVE TOWARD DEFICIT. THUS, ECONOMIC POLICY SHOULD (CONSISTENT WITH AVOIDING REIGNITION OF INFLATION) ACT TO BRING ABOUT AN EXPANSION OF DOMESTIC DEMAND GREATER THAN THAT OF GNP. SUCH A CHANGE IN PATTERN OF GNP GROWTH WOULD BE ASSISTED BY ALLOWING APPRECIATION OF THE YEN EXCHANGE RATE. MISSION WOULD OFFER ABOVE IN THE WAY OF A COMMENT, WITHOUT NECESSARILY SOLICITING JAPANESE RESPONSE (WHICH PREDICTABLY WILL BE THAT ALL TARGETS WILL BE MET).

(B) SECRETARIAT FORECASTS JAPANESE CURRENT ACCOUNT SURPLUS OF \$6 BILLION IN 1977. GOJ FORECASTS RETURN TO BALANCE BY APRIL, 1978. AT JUNE 6-7 SHORT-TERM FORECASTERS MEETING AND AT JUNE 14-15 ECONOMIC POLICY COMMITTEE MEETING, JAPANESE INDICATED THAT THEY HAD NOT FORECAST PRECISE CURRENT ACCOUNT BALANCE EXPECTED FOR CY 1977. NEVERTHELESS, MISSION WOULD PROBE FURTHER, NOTING THAT JAPANESE PROJECTIONS OF IMPORT/EXPORT AND INVISIBLES TRENDS WHICH PRODUCE CURRENT ACCOUNT BALANCE IN APRIL, 1978, SHOULD ALLOW JAPANESE TO COME TO A SPECIFIC FIGURE FOR 1977;

(C) JAPANESE HAVE INDICATED IN VARIOUS OECD FORA THAT GROWTH OF MANUFACTURING INVESTMENT IS IMPORTANTLY A

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FUNCTION OF EXPORT GROWTH. THIS RELATIONSHIP WOULD SEEM TO PLACE LIMITS IN GOJ TO SKEW GNP GROWTH TOWARD DOMESTIC DEMAND. MISSION WOULD SOLICIT JAPANESE DEL'S VIEWS ON IMPORTANCE OF THIS CONSTRAINT, AS WELL AS ON POLICIES WHICH COULD BE EFFECTIVE TO BRING ABOUT ITS RELAXATION;

(D) MISSION WOULD ASK JAPANESE DEL TO COMMENT ON SECRETARIAT ANALYSIS OF CAPACITY UTILIZATION RATES, PROFITS, AND FINANCIAL STRUCTURE OF FIRMS AS THEY CAN BE EXPECTED TO INFLUENCE GROWTH OF PRIVATE INVESTMENT IN SHORT RUN;

(E) SECRETARIAT OBSERVES THAT LOWER GROWTH RATE PLANNED OVER MEDIUM TERM IS LIKELY TO HAVE CONTINUED ADVERSE EFFECT ON INVESTMENT SPENDING. IN ADDITION, SLOWER OUTPUT GROWTH, COMBINED WITH CONSTANT (OR EVEN SOMEWHAT LOWER) GROWTH RATE OF LABOR FORCE IMPLIES DECLINE IN LABOR PRODUCTIVITY AND HENCE IN GROWTH OF CONSUMPTION  
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WHICH WOULD BE CONSISTENT WITH AVOIDING HIGHER INFLATION. SINCE EXPORTS ARE NOT LIKELY TO REMAIN AS ENGINE OF JAPANESE GROWTH, PUBLIC SECTOR MAY HAVE TO MAKE UP DIFFERENCE BETWEEN GROWTH OF PRIVATE DEMAND AND TARGETED RATE OF GNP GROWTH TO 1980 (6.3 PERCENT). GOJ PLANS TO REDUCE PUBLIC SECTOR DEFICIT OVER MEDIUM TERM. THIS OBJECTIVE IS ADMIRABLE, BUT MAY NOT BE FEASIBLE IN LIGHT OF ABOVE CONSIDERATIONS. MISSION WOULD SOLICIT JAPANESE VIEWS ON THIS QUESTION.  
SALZMAN



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